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May 2015

EQUITY MARKETS COMMENTARY

STOCKS CONTINUE TO RISE, WITH SOME SETTING NEW HIGHS

The major US equity benchmarks reached record highs in April before falling back at the end of the month, ending with modest gains. Notably, the technology-heavy Nasdaq Composite Index finally managed to surmount the levels it achieved at the height of the dot-com bubble in March 2000, although it remained well below that peak on an inflation-adjusted basis. A rebound in oil prices led to strong performance for energy shares, and materials and telecommunication services stocks were also strong. A sharp pullback in biotechnology stocks and some other highly valued segments left half of the sectors in the S&P 500 Index in the red for the month, with health care performing worst. Smaller-cap stocks, which typically have a greater focus on domestic growth, underperformed as the US dollar weakened.

Outside of the US, markets produced strong results as most major non-US currencies strengthened versus the US dollar. Stocks in Norway, Portugal, and Austria produced the best returns among European markets. In a positive sign for the eurozone, private sector lending rose for the first time in about three years, suggesting that the European Central Bank's stimulus efforts are encouraging consumers and businesses to increase borrowing. Hong Kong and Singapore led Asian markets, but shares in Japan also did well

OUTLOOK

UNITED STATES: The US economy is on sound footing. T. Rowe Price Chief US Economist Alan Levenson notes that unseasonably bad weather played a role in the economic slowdown, just as it did last year. Much of the weakness in March hiring was concentrated in weather-related industries, such as construction, and he expects growth to pick up again later in the year, as job and wage gains feed through to increased consumer spending. Indeed, news arrived at the end of the month that weekly jobless claims had reached their lowest level in 15 years, and measures of consumer sentiment remained elevated.

Perspectives on current stock valuations vary among T. Rowe Price managers, with some reporting finding greater difficulty in locating stocks that meet their investment criteria. The exceptional length of the current bull market is also a concern, as is weakness in many non-US economies. Nevertheless, they note that healthy corporate balance sheets and cash flows offer companies the flexibility not only to return capital to shareholders through dividends and share buybacks, but also to increase hiring, pursue mergers and acquisitions, and increase capital expenditures. All of these factors are likely to provide support to both the market and the overall economy in coming months.

There continues to be much debate about when the US Fed will raise interest rates. However, even when the Fed does begin to hike rates, it is most likely to be at a measured pace in order to assess the potential reverberations through financial markets and impact on growth. It is important to remember, however, that when interest rates do eventually normalise this will not necessarily be bad for stock prices. Higher rates often coincide with improved economic conditions, which typically bode well for equities.

EUROPE: European stock markets have continued to climb higher as QE and a lower euro have supported share prices. However, more and more we are seeing better results coming from the corporate side. It is also encouraging that more domestically-orientated companies seem to be coming through the worst as the eurozone economy begins to recover.

On a country basis, economic conditions are varied and we continue to see areas of opportunity. Within the periphery, unemployment remains stubbornly high, although progress on structural reforms and falling wages has led to improved competitiveness, which should provide a boost to external balances and aid economic activity in the region.

Although recent investor confidence has lifted valuations from their historic lows, on a cyclically adjusted basis, the P/E ratio for the European market is currently around 16-times versus a longer-term average of closer to 20 times. As this measure utilises the average of the last 10 years' earnings, we believe it is a useful indication to the market's attractiveness assuming a normalised level of earnings. This measure is also attractive relative to other developed markets. On the same measure, Japan and the US trade at over 26- and 24-times respectively.

JAPAN: We are optimistic regarding the Japanese economy and the ability of Japanese corporates to deliver further earnings growth. We believe the domestic economy is improving, with signs of wage increases likely to translate to real wage inflation for the domestic consumer after a year when Japan's collective consumption power was squeezed by tax increases (the Consumption Tax rate was increased from 5% to 8% in April 2014). In addition, Japan has been a heavy importer of energy ever since the Fukushima nuclear disaster in 2011 and the recent weak oil price should be supportive for the economy.

Alongside equity market gains boosting wealth for Japanese investors, real estate prices have also been increasing. The wealth creation impact of Abenomics should bode well for sentiment and economic activity levels, especially if real incomes do start to rise.

One soft spot in the backdrop is that manufacturing capex remains weak. We believe this is primarily due to companies remaining cautious about the recovery in Europe and a potential slowdown in China and we would expect some normalisation if the global economic cycle improves at the margin – an assumption we hold at present.

In general, we are increasingly optimistic about the outlook for Japanese equities, albeit we are conscious that we are not alone in this view, which in itself can create risk. We believe Japan combines both a domestic and later cycle earnings growth story with attractive valuations, together with some selective self-help reform that will structurally improve Japan's profitability. This could be a very powerful driver of returns if we are right.

Also, following the significant shift towards domestic equities from the vast Government Pension Investment Fund (as well as Japan Post); this means that there is a very large buyer of the market. We would caution, however, that Japan remains heavily exposed to the global economic cycle. Any weakness or slowdown in the US or China will impact Japan. But given the domestic story and low valuations relative to peers, we believe Japan equities are attractive despite the strong run.

EMERGING MARKETS: The backdrop for EM equities remains favourable. With indications that most central banks plan to maintain interest rates at lower levels for longer, this means the search for capital appreciation will continue and EMs remain a great source for this.

Some will point to the sell-off in EMs in the summer of 2013 on the announcement that the US Federal Reserve's was 'tapering' it's QE programme, and many investors are now worrying over a repeat sell-off as we approach the long anticipated first hike in US interest rates.

When US interest rates do start to rise, EM stocks may indeed suffer a temporary pullback, but we do not expect the economic impact to be significant. Short term, it may create some uncertainty as the hunt for yield in EMs may start to look less attractive. However, much will depend on why rates are hiked, and at what pace. If rates rise at a moderate pace because the US economy is doing well, it would be a good sign for the global economy, and should be positive for emerging markets.

We expect dispersion and volatility within markets to continue, so careful stock selection will be important to long-term performance. Although valuations are not as compelling as they were a year ago, EMs overall are still trading at a discount relative to their history, and continue to look attractive versus their developed-market peers. However, investors will have to be much more granular in their approach. We are likely to see a much more uneven world going forward, with less correlation and more dispersion of returns at both a country and sector level.

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